7 Economic consequences of Brexit strategy for Hungary

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Potential effects of Brexit on the Hungarian economy

Direct trade between Hungary and the UK has been quite modest, which means that one should not expect a significant impact of Brexit on the Hungarian economy, whatever the effect on its volume. The UK's share in Hungarian exports was 4.3% in 2015, and only 1.7% of Hungary's total imports came from the UK. Hungary has a modest share of the UK's trade – 0.3% of exports, and 0.8% of imports. The main Hungarian export products to the UK are nuclear reactors, boilers, machinery and mechanical appliances; electrical machinery and equipment; vehicles other than railway or tramway; and optical instruments. The main UK export products to Hungary are pharmaceutical products; nuclear reactors, boilers, machinery and mechanical appliances; electrical machinery and equipment; vehicles other than railway or tramway; and optical instruments.

However, Hungary's trade-induced losses due to Brexit are estimated to be relatively large in spite of these low shares in direct trade, with Breinlich et al. (2016, p. 131) estimating the losses at 0.3% of GDP. In relative terms, this is larger than the losses for (in decreasing order) the Czech Republic, Sweden, Germany, Poland, Slovakia, Finland, France, Portugal, Austria, Romania, Spain, Italy, Slovenia and Greece, but less than the losses for Ireland, the rest of EU (smaller countries taken together consisting of the Baltics, Bulgaria, Cyprus, Luxemburg, Malta), the Netherlands, Belgium and Denmark. The same study estimates that the trade effect on UK GDP will be in the range of 1.3% to 2.8%, depending on the scenario. Under an optimistic scenario, the UK is assumed to negotiate a Norway-like deal and tariffs remain at zero, but non-tariff barriers increase to one quarter of the reducible barriers faced by US exporters to the

EU. The authors further assume that the UK will not benefit from additional intra-EU integration, through which non-tariff barriers will fall 20% faster than in the rest of the world. They also factor in a 17% reduction in the UK's fiscal contribution to the EU (the same as Norway), a saving of 0.09% of UK GDP. Their pessimistic scenario supposes that the UK and the EU impose MFN tariffs on each other. Non-tariff barriers increase to three-quarters of the reducible barriers faced by US exporters to the EU. Further, the UK is excluded from additional EU integration, through which non-tariff barriers are assumed to fall 40% faster than in the rest of the world. In this scenario, they assume that the UK will save 0.31% of GDP on its fiscal contribution to EU budget. UK exports to the EU will fall by between 11% and 31% in the short run, and the long-run effects will be larger at somewhere between 25% and 44%. In the two extreme scenarios, EU exports to the UK will fall by between 10% and 29% in the short run, and by between 27% and 38% in the long run.

The second-round effects, however, are more important than the direct effects. They come from the fact that Germany is far more important to Hungary than the UK is. Germany's shares of Hungarian trade are 30.3% of exports and 23.5% of imports. (More or less the same is true for Slovakia although with somewhat lower trade exposure to Germany; countries in a similar position are also exposed to the second-round effects). Hungarian trade with Germany is large and may affect UK-German trade. One third of German exports to the UK consist of vehicles other than railway or tramway, a product group that represents a quarter of Hungarian exports to Germany. Product-level case studies might offer some insights into the conversion rate – that is, the extent to which Hungarian exports to Germany affect the German exports to the UK. Unfortunately, we do not have adequate case studies, but it is highly probable that Hungarian exports to Germany do in turn generate German exports to the UK.

Export and import transactions are especially linked to each other when exports and imports take place within the same firm or along the same supply chain. This suggests that the bulk of the economic effect of Brexit on Hungary via the trade channel may come not from the direct trade flow, but rather from second-round effects via Germany. If Germany trades less with the UK after Brexit, this will have a larger effect on Hungarian welfare than the loss due to the decrease in direct trade between UK and Hungary.

FDI from UK to Hungary has been quite volatile. For example, its share in overall inflows was 16% in 2012-2013, but was close to zero in 2014. Up to 2014, the UK's share in the stock of FDI in Hungary was 3.8%. The UK is the seventh largest investor in the country, and it mainly invests in the retail, telecommunications and professional services sectors. The largest companies in Hungary that are owned either fully or partly by UK investors are Tesco, Shell, Unilever, Glencore, Vodafone, Invitel, British American Tobacco Hungary, Imperial Tobacco Hungary, Reckitt Benckiser, and GlaxoSmithKline.

The UK is the second most popular destination (behind Germany) for Hungarian emigrants working abroad. According to official statistics, after Hungary's EU accession, the number was slightly below 40,000 until 2010. In the following six years their number increased rapidly, with an annual inflow of more than 20,000 in each year. These emigrants are younger, more skilled and more educated than the median Hungarian employee or job seeker. More specifically, two subgroups can be identified: skilled workers, and employees with a higher education. One quarter of these work in hotels and restaurants, and their share is significantly larger than that from other member countries joining the EU in 2004 or later. The share of health and social workers among Hungarians working in the UK is also significantly higher than for these countries. The share of workers in the manufacturing and building industry is lower, however, and is very similar to that of the EU15.

A large increase in foreign remittances – reaching 3.2% of Hungarian GDP in 2014 – can be explained by this increase in emigration. The UK was the fourth largest source country behind Germany, the US and Canada, with around €360 million.

Main elements of Hungary's strategy for Brexit

It is obvious that Brexit will have non-negligible consequences for Hungary through all three channels – trade, labour and capital. Although it may seem that the welfare loss due to trade is not significant, it is not its estimated magnitude in itself that should generate major concern. Its overall effect may be larger due to second-round channels, and this is why the Hungarian negotiating partners should attach high importance to the trade chapter.

Trade and labour movement issues will be linked during negotiation, as there seems to be no easy compromise between the positions of the UK and the EU. If the UK prefers a free trade agreement (FTA) with discretionary regulation of labour movement from the EU, and the EU insists on the Single Market – i.e. an FTA must go hand-in-hand with free movement of EU labour – it is hard to foresee a compromise.

Hungary has benefitted from a UK labour market that has welcomed highly skilled and highly educated immigrants. The UK labour market holds great value in the eyes of Hungarian job seekers abroad, and there is no close substitute in the EU on such a scale. It will take some time for potential migrants to react to new rules of entry into the UK labour market. However, as the negotiation will last for a while, assuming the push factors still dominate, potential migrants will have enough time to acquire the skills necessary for an alternative target country. According to the literature on the welfare effects of migration on source countries, well-designed domestic policies are the appropriate answer to the potential emigration outflow.

If, as can be assumed, the trade and labour markets will be tied to each other in the negotiations, two main broad options emerge: free labour movement with a custom union, or discretionary labour regulation with tariffs and non-tariff barriers. If the 'free' option is impossible for political reasons, then the negotiations will be over the parameters and the conditions of the departure from free trade. The UK seems to have a hard stance on labour, but it should be ready to give up much more in terms of free trade to achieve discretionary labour measures, as the trade-induced losses are highly asymmetrical between the UK and the EU. Any significant departure from free trade will be accompanied by new, additional financial market barriers. The above estimations do not deal with the effect of increasing frictions in financial flows between the UK and the EU – their effect on welfare might be as negative as that of new tariffs and new trade barriers.

A few countries may even see some short-term gain from reduced access to the UK labour market, as fewer skilled and highly educated emigrants leave their countries. These are mostly countries from the EU8 – especially Bulgaria, Hungary Poland, and Romania. However, any short-term welfare gains in the labour market will be exceeded by the losses through the trade channel. In addition, the short-term labour market gains might not even be realised if the new UK labour regulations do not dampen the emigration push factors in Hungary and in other central and eastern European countries. And the short-term effects – if they exist at all – will doubtless evaporate in the long run. Therefore, it is important for the Hungarian negotiators to understand that their eventual reluctance to join the EU's hard stance on the trade front will not be compensated by the welfare gain on labour. This is why the Hungarian strategy should take into account that any concession on labour market regulations will have consequences for the trade channel. It should be clear that any bartering over the labour market for trade concessions might have a negative overall effect on Hungarian welfare.

The Hungarian long-term interest is to take advantage of trade with UK, be it direct or indirect. It follows that Hungary has a strong interest in allying itself with Germany over trade. However, the large EU countries will take a hard stance on the potential trade-off between trade and labour deviations from the free option. Their initial readiness to swap deviations from the free option in trade and labour might be significantly different from that of Hungary, which is comparable to that of countries with similar trade and labour exposures to UK (such as Slovakia, the Czech Republic and Poland). However, if these countries together with Hungary make efforts to impose their negotiating position – that is, appearing ready to accept the UK's hard stance on labour – on others, then the overall trade-related welfare outcome might be in jeopardy as a harder stance on trade will be the unavoidable final outcome. As the final agreement should be unanimously voted on, any serious disagreement between the EU15 and the EU8 may provide an additional argument in favour of a two-speed EU.

The Brexit negotiation will be instrumental in the future of the EU, and economic considerations will certainly be heavily influenced by more general issues on the EU agenda. Hopefully it will become clear to the participating countries that disintegration would be costly, and that significant welfare losses are unavoidable. It may serve as a disciplinary device to deter other countries from even considering exit.

What is required?

According to the UK's Department for International Trade, the benefits for UK businesses exporting to Hungary include English being accepted as a business language, a western-style business culture, over £28 billion EU funding between 2014 and 2020, and the

UK 'brand' being viewed positively. The strengths of the Hungarian market include its strategic location in the heart of Europe, a well-developed transport network, an open economy, good infrastructure and communications, and its investment incentives. Hungary ranks 54th in the World Bank's *Ease of Doing Business* report, but the report places Hungary 110th in terms of protecting investors. Despite Hungary's increasingly westernised business culture, UK companies can encounter difficulties there, including bureaucracy, corruption, language difficulties (especially for smaller companies and outside Budapest) and legal barriers in public procurement. Obviously, these difficulties have nothing to do with Brexit and their removal should have a positive effect on both trade and FDI with all countries.

Whatever the final outcome of the UK-EU negotiations, Hungary will surely remain popular among British stag parties and 'ruin bar' visitors, and Hungarian dentistry services will still be used extensively by British patients. Whatever the overall impact of this on Hungarian welfare, however, it will not compensate for the potential loss from falling UK-EU trade.

Reference

Breinlich, H., S. Dhingra, S. Estrin, H. Huang, G. Ottaviano, T. Sampson, J. Van Reenen and J. Wadsworth (2016), "BREXIT 2016: Policy Analysis from the Centre for Economic Performance", London.

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